

Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. **78-698**

MANDELL SHIMBERG, JR., and ELAINE F. SHIMBERG,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioners, MANDELL SHIMBERG, JR., and ELAINE F. SHIMBERG, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on July 28, 1978.

OPINIONS BELOW

The order of the District Court for the Middle District of Florida (Appendix A, *infra*, pp. A1-A10) granting judgment for Petitioners is reported at 415 F. Supp. 832. The opinion of the United States Court of Appeals for the Fifth Circuit reversing the judgment of the district court (Appendix C, *infra*, pp. A12-A26) is reported at 577 F.2d 283.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit (Appendix D, *infra*, p. A27) was entered on July 28, 1978. This petition for a writ of certiorari was filed within ninety (90) days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the *meaningful reduction* test for determining dividend equivalence in corporate redemptions under Section 302(b)(1) of the Internal Revenue Code of 1954 (the "Code"), as enunciated by this Court in *United States v. Davis*, 397 U.S. 301 (1970), is applicable under Section 356(a)(2) of the Code to corporate reorganizations where a stockholder of a merged corporation receives cash in addition to stock and securities of the continuing corporation.
2. Whether an integrated tax-free merger may be fragmented into separate steps for the purpose of analyzing under Section 356(a)(2) of the Code a boot distribution incident to the merger.

STATUTORY PROVISIONS INVOLVED

Sections 302 and 356 of the Internal Revenue Code of 1954, 26 U.S.C. 302 and 356, provide in pertinent part as follows:

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule*.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges*.—

(1) *Redemptions Not Equivalent to Dividends*.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

* * *

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) *Gain on Exchanges*.—

(1) *Recognition of Gain*.—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as Dividend.*—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

STATEMENT OF THE CASE

The facts in this proceeding were fully stipulated and may be summarized as follows.

Prior to December 9, 1970, LaMonte-Shimberg Corporation ("LSC") was a local Florida corporation engaged primarily in the business of building and selling single family houses. Petitioner¹ was its president, chief executive officer and majority stockholder, owning directly and indirectly 68.43% of its 135,521 issued and outstanding shares of LSC capital stock. The balance of its outstanding LSC stock was owned by 19 unrelated stockholders.

MGIC Investment Corporation ("MGIC"), a "publicly held" corporation, the stock of which was registered and traded on the New York Stock Exchange, was a holding company engaged through its various subsidiaries primarily in the financial guaranty business, insuring lenders and lessors against credit and rental losses in the real estate financing business. Immediately prior to the events of December 9, 1970, a total of 6,204,448 shares of MGIC common stock were issued and outstanding, being held by some 5,191 stockholders of record.

MGIC's financial statement for December 31, 1970, reflected ownership of assets having a value of \$250,527,729, liabilities of \$170,433,208 and stockholders' equity of \$80,094,521. By comparison, LSC's consolidated balance sheet for October 31, 1970, showed assets of \$6,047,122, liabilities of \$5,225,126 and stockholders' equity of \$821,996.

1. References to "Petitioner" are to Mandell Shimberg, Jr. Petitioner Elaine F. Shimberg is involved in this proceeding only because she filed a joint Federal income tax return with Mandell Shimberg, Jr. for the calendar year 1970.

The financial conditions of MGIC and LSC were substantially the same at the time of the merger as they were on December 31, 1970 and October 31, 1970, respectively.

Pursuant to the terms of a merger agreement executed on September 18, 1970 and consummated on December 9, 1970, LSC was merged into MGIC in a transaction which qualified as a reorganization under the provisions of Section 368(a)(1)(A) of the Internal Revenue Code of 1954 (the "Code").²

Incident to the merger, the LSC stockholders received in the aggregate a pro rata distribution of cash in the amount of \$625,000 plus a total of 32,132 shares of MGIC common stock outstanding and an additional 32,132 MGIC common shares placed in escrow subject to an earnout. Petitioner, in exchange for his LSC stock, received \$417,449 in cash plus 21,461 shares of MGIC common stock and a like number of MGIC common shares in escrow. After consummation of the merger, Petitioner owned less than 1% of the issued and outstanding common stock of MGIC.

On his federal income tax return for 1970, Petitioner reported the cash received incident to the merger as long-term gain from the sale of a capital asset. Upon audit, the Internal Revenue Service determined that the cash was taxable as a dividend. Petitioner paid the resulting deficiency under protest, and following denial of his claim for refund, initiated suit for refund in the district court.

The parties stipulated that the merger of LSC into MGIC constituted a "reorganization" within the meaning of Section 368(a)(1)(A) of the Code and that Petitioner was entitled to capital gain treatment with respect to the

cash received unless the payment of the cash had "the effect of the distribution of a dividend" within the meaning of Section 356(a)(2) of the Code.

The district court found (Appendix A, *infra*, pp. A7-A10) that the principles enunciated by the Eighth Circuit in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973) were controlling, and held that the cash received by Petitioner pursuant to the reorganization did not have the effect of a dividend because there had been a *meaningful reduction* in the nature of Petitioner's interest in the continuing enterprise. The district court noted (Appendix A, *infra*, pp. A8-A9) that Petitioner had been president, chief executive officer and owner of approximately 66% of the stock in LSC prior to the merger, and subsequently held less than 1% of the outstanding stock of MGIC. Because the district court determined (Appendix A, *infra*, p. A9) that the loss in valuable corporate rights resulting from the reorganization constituted a *meaningful reduction*, the district court held in favor of Petitioner.

On Respondent's appeal to the Court of Appeals for the Fifth Circuit, that court reversed, holding that the *meaningful reduction* test enunciated by this Court in *United States v. Davis*, 397 U.S. 301 (1970), and as utilized in *Wright*, was not applicable to the facts of the present case. Instead, the court (Appendix C, *infra*, p. A22) deemed the cash received by Petitioner to be part of a hypothetical pro rata distribution by LSC to its stockholders. The court found on this analysis that the distribution had the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2) and reversed the judgment in favor of Petitioner. (Appendix C, *infra*, pp. A22-A23, A26).

2. All references to section numbers, unless otherwise expressly indicated, are to the Internal Revenue Code of 1954.

REASONS FOR GRANTING THE WRIT

1. The Decision of the Fifth Circuit in This Case Is in Direct Conflict With Decisions of the Courts of Appeals for the Second and Eighth Circuits and the Court of Claims.

In 1970 the Court in *United States v. Davis*, 397 U.S. 301 (1970), prescribed the *meaningful reduction* test for determining dividend equivalence under Section 302(b)(1) in corporate redemption transactions. No comparable test has been provided by this Court for determining the dividend effect of boot distributions under Section 356(a)(2). However, when faced with this precise question, the Eighth Circuit in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), following the rationale of the Second Circuit in *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956) and the Court of Claims in *Ross v. United States*, 173 F. Supp. 793 (Ct.Cl. 1959), cert. denied, 361 U.S. 875 (1959), held that Section 302(b)(1) and Section 356(a)(2) should be read *in pari materia* and concluded (428 F.2d at 605) that the appropriate measure to be applied to Section 356(a)(2) boot distributions was the *meaningful reduction* test enunciated by the Court in *Davis*.³

In explaining its application of the *Davis* test in the context of a reorganization, the Eighth Circuit in *Wright* stated (482 F.2d at 605):

We read [the 'meaningful reduction'] language and *Davis* as holding that the proper inquiry is the percentage change of ownership in the corporation and the attendant overall results due to that change. Stated

otherwise, the basic inquiry is whether the distribution had the 'net effect' of a dividend. [Citations omitted.]

We think that if a distribution is not to have the 'net effect' of a dividend, there must have occurred a meaningful reduction of the redeeming shareholder's proportionate interest or in other words a *meaningful change in the relative economic interests or rights of the shareholder after the redemption*. . . .

. . . [V]iewing the transaction as a realistic whole, the taxpayer has reduced his holding in [the preexisting corporation] from almost complete ownership in [that corporation] to 61.7 per cent ownership in [the surviving corporation]. . . . [Emphasis added.]

As noted by the Eighth Circuit, the Government in *Wright* agreed that Section 302(b)(1) and Section 356(a)(2) should be read *in pari materia*.⁴ Thereafter, the Internal Revenue Service published its accord with this statutory construction. Rev. Rul. 75-83, 1975-1 C.B. 112. See also Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121.

It was the *Davis* *meaningful reduction* test and the *Wright* analysis of *viewing the transaction as a realistic whole* which the district court below applied to find that the boot received by Petitioner incident to the merger was taxable as capital gain.

In reversing, the Fifth Circuit refused to apply in this case either the *Wright* analysis or the *Davis* teachings. Thus, the Fifth Circuit held (Appendix C, *infra*, p. A19):

4. The Government's agreement reflected a major shift in policy from its "automatic dividend" position following the Court's decision in *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 14.34 at 14-92 (3d Ed. 1971).

3. See generally Levin, Adess and McGaffey, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 *The Tax Lawyer* 287 (1977).

The 'meaningful reduction' test cannot be indiscriminately applied in the reorganization context. The *Davis* case illustrates its proper application in a redemption under § 302, as does the recently decided case of *Morris v. United States*, 441 F.Supp. 76 (N.D. Tex. 1977), while *Wright* indicates that it also is appropriate when a reorganization can be realistically treated as a redemption. Even assuming that *Wright* is correctly decided—a point on which we express no opinion—the instant case presents radically different facts and calls for correspondingly different analysis. We agree with the government that 'the undifferentiating invocation of stock redemption principles in a reorganization case' such as this one is erroneous, and we decline to apply on a wholesale basis the 'meaningful reduction' test in cases arising under § 356(a)(2). [Footnote omitted.]

In explaining its refusal to follow *Wright* and *Davis*, the Fifth Circuit said (Appendix C, *infra*, p. A20) that the application of Section 302 principles "would render § 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations."

Indeed, according to the Fifth Circuit (Appendix C, *infra*, p. A22):

... § 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred. This inquiry is essentially a comparison of the effect of actual distribution and the effect of a hypothetical one. [Emphasis added.]

Certainly the courts must recognize the factual differences inherent in redemptions and corporate reorganizations. However, Petitioner submits that the legal guidelines for determining dividend effect under Section 356(a)(2) should be the same as those used in determining dividend equivalence under Section 302(b)(1). Indeed, the Internal Revenue Service and the courts which have considered the statutory construction issue, with the exception of the Fifth Circuit in this case, are in agreement that Section 302(b)(1) and Section 356(a)(2) are to be read *in pari materia*.⁵

The uncertainty in the law resulting from the Fifth Circuit's failure to follow the *Wright* analysis and the *Davis* guideline concerning boot distributions in tax-free corporate reorganizations will seriously undermine the planning of such transactions in the future, and the administration of the Internal Revenue Code with respect thereto.

2. The Decision Below Sanctions a Bifurcation of an Integrated Transaction Contrary to the Step Transaction Doctrine, Section 356(a)(2) and the Decision of the Eighth Circuit in *Wright v. United States*.

The step transaction doctrine requires that all parts of an integrated multi-step exchange or reorganization be grouped together to determine the appropriate tax treatment for the entire transaction. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942). The Eighth

5. *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973); *Hawkinson v. Commissioner*, 235 F.2d 747, 751 (2d Cir. 1956); *Ross v. United States*, 173 F. Supp. 793, 797 (Ct.Cl. 1959), cert. denied, 361 U.S. 875 (1959); Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121; Rev. Rul. 75-83, 1975-1 C.B. 112.

Circuit's analysis of the facts in *Wright v. United States* was in accord with the step transaction doctrine.

Although the Fifth Circuit recognized the existence and validity of the step transaction doctrine (Appendix C, *infra*, p. A24), it reasoned that this doctrine was not a bar to the fragmenting of the merger between LSC and MGIC into parts and the consideration of a hypothetical pre-merger pro rata distribution. The Fifth Circuit explained (Appendix C, *infra*, p. A24) that it was not treating the hypothetical boot distribution as a separate step in an overall transaction but rather "analyzing the distribution in accordance with the requirements of § 356 (a)(2)."

Neither the language of Section 356(a)(2), its legislative history, nor business reality supports the conclusion that a statutory merger can be fragmented or a portion of the operative facts disregarded. There is nothing on the face of the statute which remotely suggests that, in making the critical determination, less than all the facts of the transaction are to be considered or that some of the facts are to be taken out of context and viewed in isolation. Moreover, the legislative history of Section 203 (D)(2), of the Revenue Act of 1924, the predecessor of Section 356(a)(2), does not suggest that the appropriate inquiry by a reviewing court is the fragmenting of the transaction and the disregarding of a portion of the facts.⁶ See *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), and *McDonald v. Commissioner*, 52 T.C. 82 (1969). Lastly, the "fragment and disregard" approach of the Fifth Circuit in making Section 356(a)(2) analyses creates uncertainty as to the circumstances in which the step transaction

doctrine will be applied and is contrary to the economic and business realities of most reorganizations.

The effect of the Fifth Circuit's opinion in this case is to disregard the step transaction doctrine. As a result, the future application of that doctrine to integrated transactions is unclear.

CONCLUSION

The tax consequences of common commercial transactions can be fairly and predictably determined only where there is a uniform administration of the tax laws. It is important to taxpayers and the Government alike that whenever possible there be certainty as to the meaning of complicated tax provisions.

For many years, it was unclear whether all boot received in a reorganization *automatically* had the effect of a dividend to the extent of earnings and profits or whether leeway existed for capital gain treatment. Following the decision in *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), the Internal Revenue Service took the position that, in situations where a taxpayer continued as a stockholder after the exchange, Section 356(a)(2) automatically converted gain recognized pursuant to Section 356(a)(1) into dividend income to the extent of earnings and profits.

However, this so-called "automatic dividend" position was strongly and effectively criticized by commentators, and the cases decided in later years retreated from that view.⁷

6. H.R. REP. NO. 179, 68th Cong., 1st Sess. (1924), 1939-1 (Part 2) C.B. 241, 252; S. REP. NO. 398, 68th Cong., 1st Sess. (1924), 1939-1 (Part 2) C.B. 266, 277.

7. *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct.Cl. 1958); (Continued on following page)

Finally, in 1974, following its agreement in *Wright* as to the applicability of Section 302 standards to Section 356(a)(2) determinations, the Service abandoned its "automatic dividend" position and accepted the reasoning that, in determining whether boot has the effect of the distribution of a dividend for purposes of Section 356(a)(2), the standards of "essential dividend equivalence" under Section 302 should be applied.⁸

As the result of the decisions of the Second and Eighth Circuits in *Hawkinson* and *Wright*, respectively, and the Court of Claims in *Ross*, and the agreement of the Service regarding the proper statutory construction, taxpayers had every reason to believe that at long last some certainty had come into the law as to the appropriate test to be applied in determining dividend effect under Section 356(a)(2). This belief was reinforced by the existence of the *Davis* guideline for determining dividend equivalence under Section 302(b)(1).

The refusal of the Fifth Circuit in this case to apply Section 302 standards and the *Davis* test to boot distributions under Section 356(a)(2) and its disregard of the step transaction doctrine reintroduces into the law a high degree of uncertainty. Indeed, the Fifth Circuit's decision to adopt a "limited automatic dividend" rule is a throwback

Footnote continued—

Ross v. United States, 173 F. Supp. 793 (Ct.Cl. 1959), cert. denied, 361 U.S. 875 (1959); *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973). See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 14.34 at 14-92 (3d ed. 1971); Wittenstein, "Boot Distributions and Section 112(c)(2): A Re-Examination," 8 Tax. L. Rev. 63 (1952). See also Levin, Adess and McGaffey, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 The Tax Lawyer 287 (1977).

8. Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121; Rev. Rul. 75-83, 1975-1 C.B. 112.

to the *Bedford* case, the point of beginning more than 33 years ago.

Only a definitive pronouncement by this Court as to the proper guidelines for determining dividend effect under Section 356(a)(2) will reconcile the conflicts among the courts and bring certainty to the law.

For the reasons set forth above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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October 24, 1978

APPENDIX

APPENDIX

APPENDIX A

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

No. 74-440-Civ-T-H

MANDELL SHIMBERG, JR. and ELAINE F. SHIMBERG,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

ORDER

(Filed July 1, 1976)

The sole issue for determination in this proceeding is whether cash in the amount of \$417,449 received by the Plaintiff, Mandell Shimberg, Jr.,¹ on December 9, 1970 in connection with the merger of Lamonte-Shimberg Corporation into MGIC Investment Corporation is taxable as proceeds from the sale of a capital asset, entitled to long-term capital gain treatment for federal income tax purposes, as contended by the Plaintiffs; or, whether the cash proceeds are taxable as a dividend or ordinary income as contended by the Defendant.

1. The Plaintiff, Elaine F. Shimberg, is involved in this proceeding only because she filed a joint federal income tax return with Mandell Shimberg, Jr. for the calendar year 1970. Unless otherwise expressly indicated, all references herein to the "Plaintiff" shall refer solely to Mandell Shimberg, Jr.

The issue has been submitted to the Court for determination upon stipulated facts contained in the parties' pre-trial stipulation. The following is a summary of the facts:

(a) LaMonte-Shimberg Corporation ("LSC") was incorporated under the laws of the State of Florida on September 28, 1959. LSC was, at all material times, engaged primarily in the business of building and selling single family homes. The Plaintiff was its president and chief executive officer.

(b) The Plaintiff was the majority stockholder of LSC, owning, directly or indirectly, approximately 90,517 shares or sixty-six per cent (66%) of its 135,521 issued and outstanding shares of common stock. The remainder of the stock of LSC was owned by nineteen unrelated stockholders.

(c) MGIC Investment Corporation ("MGIC") is a corporation organized and existing under the laws of the State of Delaware, having been incorporated in that state in 1968. MGIC was, at all material times, a "publicly held" corporation, the stock of which was traded on the New York Stock Exchange, engaged through its various subsidiaries primarily in the financial guaranty business, insuring lenders and lessors against credit and rental losses in the business of real estate financing.

(d) On November 9, 1970, 6,204,448 shares of MGIC common stock were issued and outstanding, being held at that time by 5,191 stockholders of record. The stock ownership of MGIC did not materially change during the period from November 9, 1970 through December 9, 1970.

(e) On September 18, 1970, MGIC and LSC executed a Plan and Agreement of Merger (the "Agree-

ment"), pursuant to which LSC was to be merged into MGIC in a transaction meeting the requirements of the applicable provisions of the Delaware General Corporation Law and the Florida Corporation Law. The Agreement contemplated that LSC would be merged into MGIC in a transaction qualifying as a "reorganization" under the provisions of Section 368(a)(1)(A) of the Internal Revenue Code of 1954, as amended, 26 USC §368.

(f) On December 9, 1970, LSC was merged into MGIC, the surviving corporation, and the separate existence of LSC was terminated. The merger was consummated in accordance with the applicable laws of the states of Florida and Delaware.

(g) In connection with the merger, the stockholders of LSC received ratably, in exchange for all of their LSC stock, 32,132 shares of MGIC common stock outright, 32,132 shares of MGIC common stock in escrow, and cash in the total amount of \$625,000. Specifically, the Plaintiff received in exchange for his LSC stock, 21,461 shares of MGIC common stock outright, 21,461 shares of MGIC common stock in escrow, and cash in the amount of \$417,449. The undistributed earnings and profits of both corporations, immediately prior to December 9, 1970, was in excess of \$625,000 each.

(h) On their joint federal income tax return for 1970, the Plaintiffs reported the cash received in connection with the merger as long-term capital gain. Upon audit and examination of the return, the Internal Revenue Service determined that the cash received by the Plaintiff in connection with the merger was taxable as a dividend or ordinary income. The Commissioner of Internal Revenue assessed a federal

income tax deficiency against the Plaintiffs in the amount of \$125,883. The amount of the deficiency, and interest in the amount of \$15,664.67, was timely paid by the Plaintiffs on June 19, 1973. Additional interest in the amount of \$505.26 was paid by the Plaintiffs on August 17, 1973.

(i) On January 4, 1974, the Plaintiffs timely filed a claim for refund with respect to the amount of the deficiency and interest paid. On May 8, 1974, the Plaintiffs were notified by the Commissioner of Internal Revenue that their claim for refund was disallowed in full.

(j) This suit for recovery of the amount of the deficiency, and all interest paid, was commenced on August 8, 1974.

Section 354 of the Code, 26 USC §354, provides that no gain or loss shall be recognized for tax purposes if, pursuant to a plan of reorganization, stock and securities in a corporation are exchanged solely for stock or securities in another corporation which is a party to the reorganization. Section 368(a)(1)(A) of the code, 26 USC §368(a)(1)(A), defines the term "reorganization" to include a "statutory merger," that is, a merger effected pursuant to the laws of one or more states. Accordingly, the Internal Revenue Code permits a stockholder to dispose of stock owned by him in a statutory merger free of federal income tax consequences so long as he receives as consideration only stock or securities of the other corporation participating in the merger.

However, most state laws, including those of Florida and Delaware,² permit consideration other than stock or

securities to be utilized in effecting a statutory merger. The additional consideration, commonly referred to as "boot," may consist of cash or any property other than the stock or securities of the acquiring corporation.

The receipt of "boot" in connection with a statutory merger does not make the transaction completely taxable; rather, it has the effect of making the ordinarily tax-free transaction partially taxable. Section 356(a) of the Code, 26 USC §356(a), provides:

"§356. Receipt of Additional Consideration

(a) Gain on Exchanges.—

(1) Recognition of Gain.—If

(A) section 354 . . . would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by Section 354 . . . to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) Treatment as Dividend.—*If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder,*

2. Sections 608.20 and 608.21, Florida Statutes; Section 252, Delaware General Corporation Law.

if any of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property." [Emphasis added.]

Accordingly, in statutory mergers involving the receipt of "boot," the recipients are required to recognize gain to the extent of the value of the "boot." The question is whether it is taxable as proceeds from the sale of the capital asset or is taxable as a dividend, and the answer turns on whether the payment and receipt of the "boot" "... has the effect of the distribution of a dividend . . ." within the meaning of Section 356(a)(2). That, of course, is the ultimate issue in this case.

Based upon the Supreme Court decision in *Commissioner v. Bedford's Estate*, 65 S.Ct. 1157, 325 U.S. 283 (1945), the Internal Revenue Service took the position for many years that, in situations where the taxpayer continued as a stockholder after a reorganization exchange, Section 356(a)(2) "automatically" treated "boot" recognized pursuant to Section 356(a)(1) as dividend income to the extent of the distributing corporation's earnings and profits. See, Rev. Rul. 56-220, 1956-1 C.B. 191. The so-called "automatic dividend" rule was criticized by the commentators, however, and the more recent cases³ tended to abandon the rigidity of that approach in favor of a more flexible analysis similar to that employed under Section 302(b)(1) (relating to dividend equivalence incident to a stock redemption.)

Accordingly, following the decision in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), the Internal Revenue

3. *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); *Hawkinson v. Commissioner*, 253 F.2d 747 (2d Cir. 1956); *Ross v. United States*, 173 F.Supp. 793 (Ct. Cl. 1959); *Idaho Power Co. v. United States*, 161 F.Supp. 807 (Ct. Cl. 1958).

Service has apparently abandoned the "automatic dividend" application of *Bedford* and has accepted the reasoning that, in determining whether "boot" has the effect of a distribution of a dividend for purposes of Section 356(a)(2), the standard of "essential dividend equivalency" under Section 302(b)(1) should be applied. (See Rev. Rul. 74-515, I.R.B. No. 1974-43, p. 7; Rev. Rul. 74-516, I.R.B. No. 1974-43, p. 9).⁴

In *United States v. Davis*, 397 U.S. 301, 90 S.Ct. 1041 (1970), the leading authority interpreting and applying Section 302(b)(1), the Supreme Court held that in deciding whether a payment in redemption of stock "is not essentially equivalent to a dividend," within the meaning of that section, the inquiry should be "whether the redemption could be characterized as a sale" (397 U.S. at 311; 90 S.Ct. at 1047); and the answer to that question, in turn, should not be sought by examining the business motives underlying the transaction, but by ascertaining whether the redemption resulted "in a meaningful reduction of the shareholder's proportionate interest in the corporation" (397 U.S. at 313; 90 S.Ct. at 1048).

Thus, in *Wright v. United States*, *supra*, the Eighth Circuit applied the *Davis* "meaningful reduction" standard in resolving the same issue of law presented by this case under Section 356(a)(2), concentrating in particular upon the taxpayer's reduction in voting power in the surviving corporation and concluding that the "boot" he received in addition to a stock-for-stock exchange arising out of

4. "The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under Section 302(b)(1) depends upon the facts and circumstances of each case." Tres. Reg. §1.302-2(b). [Emphasis supplied]

a corporate consolidation did not have "the effect of a distribution of a dividend" under Section 356(a)(2).⁵

In the final analysis, therefore, the issue in this case under Section 356(a)(2), as to whether the payment of the "boot" had the "effect of the distribution of a dividend," must be treated as an ultimate issue of fact to be resolved by an examination of the total transaction and its resulting effect upon the interests of the taxpayer as a stockholder. Stated more precisely the factual question is whether sale or dividend characteristics predominate in the transaction, regardless of the underlying motives of the parties; and the test to be applied in answering that question is whether the transaction resulted "in a meaningful reduction of the shareholder's proportionate interest in the corporation."

Prior to the merger in this case, Plaintiff was the president, chief executive officer and owner (directly or indirectly) of approximately 66% of the stock of LSC. As a result, under Florida law he could effectively control the corporation. Subsequent to the merger the Plaintiff

5. In resolving the sale-or-dividend issue under Section 356(a)(2) the Court in *Wright* first devoted considerable space in its opinion to an analysis of the reorganization under the so-called "safe harbor" or "substantially disproportionate redemption" provisions of Section 302(b)(2). In so doing the Court viewed the transaction involved as one in which only stock was issued, followed by a fictional redemption by the acquiring corporation of a portion of its newly issued stock for the "boot." The Court concluded, nevertheless, that the "boot" would not qualify as the proceeds of a "redemption" under the mathematical limitations of Section 302(b)(2), and then turned its attention to the general, dividend equivalence test of Section 302(b)(1) to resolve the parallel issue presented under Section 356(a)(2). Thus, to the extent the opinion might suggest application of Section 302(b)(2) in a reorganization context governed by Section 356(a)(2), it is a dubious dictum and need not be pursued here despite Plaintiff's contention that his resulting stock position in MGIC would meet the requirements of Section 302(b)(2) should that analysis be made in this case.

owned (directly and indirectly) less than 1% of the outstanding common stock of MGIC, a large publicly-held corporation whose stock was traded on the New York Stock Exchange and was held by approximately 5,200 shareholders. His former rights to direct the affairs of LSC were extinguished. His interest in MGIC afforded him no control whatsoever over the destiny of the large national corporation. No longer was he the major "owner" of a successful local company operating in several Florida counties. He was then the holder of a minuscule percentage of the outstanding stock of a huge, publicly-held corporation. It is clear that the merger resulted in a radical change and meaningful reduction in the nature of the Plaintiff's interest in the continuing business. The net effect of the transaction was a sale by the Plaintiff and the other LSC stockholders of their LSC stock to MGIC for cash and marketable securities in a publicly owned corporation.⁶

The Court concludes that the cash or "boot" received by the Plaintiff on December 9, 1970, in connection with the merger of LSC into MGIC did not have "the effect of the distribution of a dividend" within the meaning of

6. The Defendant, in apparent reliance upon that portion of the *Wright* opinion discussed in the preceding footnote, contends that the scope of the inquiry should be a narrow one, i.e., that the "meaningful reduction" test should not be applied on a before and after basis, but should be restricted to a post merger comparison between what the taxpayer's interest in the resulting consolidated corporation would have been with and without the boot payment. *Wright* does not support such a myopic view of the consequences of the transaction in determining Section 302(b)(1) "dividend equivalence" in resolving the parallel issue presented under Section 356(a)(2). The other authorities cited by the Defendant, namely *King Enterprises, Inc. vs. United States*, 418 F.2d 511 (Ct. Cl. 1969), and *Ross vs. United States*, 173 F.Supp. 793 (Ct. Cl. 1959), cert. denied, 361 U.S. 873 (1959), are inapposite on their facts, involved minority shareholders, and did not have the benefit of the teachings of *Davis*.

Section 356(a)(2) and is taxable as proceeds from the sale of a capital asset. It follows that the Plaintiffs are entitled to recover and the parties are directed, pursuant to paragraph 6(t) of the pre-trial stipulation, to submit an agreed form of judgment within forty days from the date hereof.

The foregoing shall constitute the Court's findings of fact and conclusions of law pursuant to Rule 52, F.R.Civ.P.

DONE and ORDERED at Tampa, Florida, this 1st day of July, 1976.

/s/ W. Terrell Hodges
United States District Judge

APPENDIX B

IN THE
UNITED STATES DISTRICT COURT FOR THE
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

CIVIL ACTION NO. 74-440-Civ-T-H

MANDEL SHIMBERG, JR. and ELAINE F. SHIMBERG,
Plaintiffs

v.

UNITED STATES OF AMERICA,
Defendant

JUDGMENT

(Filed August 2, 1976)

Pursuant to the findings of fact and conclusions of law by the Court in its order, entered in this cause on July 1, 1976, it is hereby

ORDERED and ADJUDGED that plaintiffs recover from the defendant income taxes and assessed interest paid by them for the year 1970 in the amounts of \$125,240.00 and \$16,087.34, respectively, together with statutory interest on the total amount of \$141,327.34 pursuant to law, and the plaintiffs are awarded their costs.

DONE and ORDERED this 2nd day of August, 1976,
at Tampa, Florida.

/s/ W. Terrell Hodges
United States District Judge

Approved as to form:

/s/ Harold W. Mullis, Jr.
Attorney for Plaintiffs

/s/ Rodger M. Moore
Attorney for Defendant

APPENDIX C

Mandell SHIMBERG, Jr. and Elaine F. Shimberg,
Plaintiffs-Appellees,

v.

UNITED STATES of America,
Defendant-Appellant.

No. 76-3749.

United States Court of Appeals,
Fifth Circuit.

July 28, 1978.

* * *

Appeal from the United States District Court for the
Middle District of Florida.

Before BROWN, Chief Judge, and THORNBERRY
and CLARK, Circuit Judges.

THORNBERRY, Circuit Judge:

If Justice Holmes was correct that "[t]axes are what we pay for civilized society,"¹ then the question in this case is how much civilization the taxpayer will be required to purchase.

More precisely, we are asked to decide the proper tax treatment of a pro rata distribution of cash to shareholders in the course of a corporate reorganization. The taxpayer contends that this "boot" should be taxed as a long-term capital gain, while the government argues that it has "the

1. *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100, 48 S.Ct. 100, 105, 72 L.Ed. 177 (1927) (Holmes, J., dissenting).

effect of the distribution of a dividend" within the meaning of 26 U.S.C. § 356(a)(2) and should thus be taxed as ordinary income. The district court agreed with the taxpayer and awarded him a substantial refund.² For the reasons stated below, we reverse.

The facts are fully stipulated. LaMonte-Shimberg Corp. (LSC), a Florida corporation engaged in home construction and sales, was controlled by taxpayer Mandell Shimberg, Jr., who owned 66.8 per cent of the stock. His wife³ owned an additional 1.6 per cent for the benefit of their children, and nineteen other unrelated persons held the remaining shares. MGIC Investment Corp. (MGIC) is a holding company incorporated under the laws of Delaware that is primarily engaged, through various subsidiaries, in the financial guaranty business. In September 1970, MGIC and LSC executed a merger agreement, pursuant to which LSC was to be merged into MGIC in a transaction qualifying for statutory merger treatment under 26 U.S.C. § 368(a)(1)(A). To so qualify, the merger must satisfy applicable state laws regarding such reorganizations.⁴ Thus, MGIC would be the surviving corporation, and the separate corporate existence of LSC would cease. Under the agreement, LSC shareholders were to receive, pro rata, \$625,000 in cash and 32,132 shares of MGIC common stock, plus another 32,132 shares in escrow to be delivered in five years if the conditions of the agreement were met.

2. *Shimberg v. United States*, 415 F.Supp. 832 (M.D.Fla. 1976).

3. Mrs. Shimberg is involved in this case only because she filed a joint income tax return with her husband for 1970, the year in question.

4. See Del.Code Ann., tit. 8, § 252 (Supp.1977); Fla.Stat.Ann. § 607.234 (1977). Section 368(a)(1)(A) also applies to consolidations, and transactions under this section are commonly known as "A" reorganizations.

The merger was consummated on December 9, 1970, and taxpayer in exchange for his LSC stock received \$417,449, plus 21,461 shares of MGIC common stock and a like number in escrow. Immediately prior to the merger, the undistributed earnings and profits of both corporations were in excess of \$625,000 each.⁵

On his federal income tax return for 1970, taxpayer reported the cash received in connection with the merger as a long-term capital gain. Upon audit and examination of the return, the Internal Revenue Service determined that the cash received was taxable as a dividend, that is, as ordinary income. Accordingly, the IRS assessed a tax deficiency against taxpayer in the amount of \$125,883. That amount, plus interest totalling \$16,169.93, was paid, and taxpayer then filed for a refund. The IRS disallowed the refund claim in full, and taxpayer commenced this suit.

Under 26 U.S.C. § 368(a)(1), six types of corporate transactions are defined as "reorganizations," among them a "statutory merger" pursuant to state law.⁶ If the corporate transaction meets one or more of these definitions and thus qualifies as a reorganization, favorable tax treatment is available under § 354(a)(1), which provides that no gain or loss shall be recognized if, pursuant to a reorganization plan, stock or securities of one corporation are exchanged solely for stock or securities of another corporation that is a party to the reorganization. Accordingly, such transactions are generally characterized as "tax-free" reorganizations.

5. As of October 31, 1970, LSC's consolidated balance sheet showed retained earnings of \$724,559, while on December 31, 1970, MGIC had retained earnings of \$34,012,746.

6. Section 368(a)(1)'A). See generally 1 Fox & Fox, Corporate Acquisitions & Mergers, ¶¶3.03, 4.02 (1977); Comment, 60 Nw.L.Rev. 655 (1965).

However, § 354(a)(1) makes clear that not all reorganizations will be entirely tax free, for it applies so long as a shareholder of one corporation receives as consideration *only stock or securities* of another corporation participating in the reorganization. Under some reorganizations—including the statutory merger—the transaction is not a stock-for-stock exchange but may involve additional consideration such as cash or property other than stock. In these circumstances, this additional consideration—commonly known as "boot"—does not qualify for tax-free treatment. 26 U.S.C. § 356(a)(1).⁷ Thus, the reorganization is only partially tax-free.

Most state laws, including the Florida and Delaware statutes applicable here,⁸ permit other consideration in addition to stock to be utilized in a statutory merger. In the instant case the "boot" was a pro rata distribution of \$625,000 to the LSC shareholders. The question in this case is not whether the "boot" is to be taxed—for § 356(a)(1) makes clear that it is—but whether it is to be taxed as proceeds from the sale of a capital asset, i. e., as a capital gain, or as a dividend, i. e., as ordinary income.

7. Section 356(a)(1) provides:

Gain on exchanges.—

(1) *Recognition of gain.*—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

8. Del.Code Ann., tit. 8, § 252 (Supp.1977); Fla.Stat.Ann. §§ 607.214, 607.234 (1977).

The answer turns on whether the payment and receipt of the "boot" has "the effect of the distribution of a dividend" within the meaning of § 356(a)(2), which provides:

Treatment as dividend.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

The district court, 415 F.Supp. 832, held that the test to be applied in determining whether the exchange had "the effect of the distribution of a dividend" is whether the transaction resulted in a "meaningful reduction" of the taxpayer's proportionate interest in the corporation, relying on *United States v. Davis*, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970), and *Wright v. United States*, 482 F.2d 600 (8 Cir. 1973). The court then compared the taxpayer's interest in the merged corporation (LSC) with his interest in the surviving corporation (MGIC). Because taxpayer held a controlling interest—68 per cent of the stock—in LSC prior to the merger and owned less than one per cent of MGIC's stock after the merger, the court concluded that the merger resulted in "a radical change and meaningful reduction" in taxpayer's interest in the continuing business and thus did not have the effect of the distribution of a dividend under § 356(a)(2). Accordingly, the court held that the "boot" was taxable as a capital gain. Unfortunately, this approach is too simplistic.

In *United States v. Davis*, *supra*, the Supreme Court was faced with interpreting 26 U.S.C. § 302,⁹ under which a stock redemption is treated as a distribution in payment in exchange for the stock and thus qualifies for capital gain treatment under certain circumstances. Under § 302(b)(1), capital gain treatment is available if the redemption is "not essentially equivalent to a dividend." However, if the redemption has dividend equivalency, it is taxed as ordinary income. Although the Court was primarily faced with two other issues,¹⁰ it followed a long line of prior decisions¹¹ in holding that to qualify under § 302(b)(1), a redemption must result in a "meaningful reduction of the shareholder's proportionate interest in the corporation." 397 U.S. at 313, 90 S.Ct. at 1048. If the redemption does not result in such a reduction, it is considered essentially equivalent to a dividend and is taxed as ordinary income. The taxpayer in *Davis* was

9. Section 302 provides, in pertinent part:

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions treated as exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

10. In resolving these questions, the Court held that the rules of attribution of stock ownership in § 318(a) apply to § 302(b)(1) and that "business purpose" was irrelevant in determining whether a redemption is equivalent to a dividend.

11. *E. g., Levin v. Commissioner of Internal Revenue*, 385 F.2d 521 (2 Cir. 1967); *Bradbury v. Commissioner of Internal Revenue*, 298 F.2d 111 (1 Cir. 1962); *Keefe v. Cote*, 213 F.2d 651 (1 Cir. 1954); *Commissioner of Internal Revenue v. Roberts*, 203 F.2d 304 (4 Cir. 1953); *Flanagan v. Helvering*, 73 App.D.C. 46, 116 F.2d 937 (1940). See also 1 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION*, § 90.100 (1974); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS*, 9-24—9-27 (3d ed. 1971).

the sole shareholder in a corporation both before and after he redeemed a certain amount of his stock and thus did not meet the meaningful reduction test. Obviously, his relationship with other shareholders in the corporation did not change and he suffered no loss of voting power or control.

In *Wright v. United States, supra*, the Eighth Circuit applied the "meaningful reduction" analysis to a corporate reorganization. There three corporations were owned and controlled by the same shareholders but in different proportions. The principal shareholders wanted to consolidate two of the corporations into a single entity in which their ownership would be approximately the same proportion as in the other corporation. This goal could not be accomplished through a simple merger because one corporation was worth about twice as much as the other. Accordingly, the reorganization required payment of a "boot" to the taxpayer to reflect his greater entitlement and to result in a new corporation with the desired ownership percentages. Even though a formal redemption did not occur, the court viewed the "boot" from the reorganization as having been paid to the taxpayer by the newly formed corporation when he redeemed his stock in that corporation—stock which never had been issued and which the taxpayer had never owned. The court thus treated the transaction as if there had been only one corporation all along and as if one shareholder had redeemed his stock. Because this hypothetical redemption resulted in a 23 per cent reduction in the taxpayer's ownership,¹² the court concluded that the "redemption" had caused a "meaningful reduction" under *Davis*. Thus, the court concluded that

the "boot" was "not essentially equivalent to a dividend" under § 302(b)(1) and therefore did not have "the effect of the distribution of a dividend" under § 356(a)(2).

Application of the "meaningful reduction" test in *Wright* was not illogical, given the court's recasting of the transaction, since a single shareholder was treated as having redeemed his stock in a single corporation. In the instant case, however, the reorganization involves two different corporations of different sizes and with different shareholders. There is no commonality of ownership as in *Wright*, and, accordingly, no opportunity for reshaping the transaction as a redemption. Moreover, there was not a single "boot" distribution to a single shareholder, as in *Wright*, but a pro rata distribution to all LSC shareholders.

The "meaningful reduction" test cannot be indiscriminately applied in the reorganization context. The *Davis* case illustrates its proper application in a redemption under § 302, as does the recently decided case of *Morris v. United States*, 441 F.Supp. 76 (N.D.Tex.1977), while *Wright* indicates that it also is appropriate when a reorganization can be realistically treated as a redemption. Even assuming that *Wright* is correctly decided—a point on which we express no opinion—the instant case presents radically different facts and calls for correspondingly different analysis. We agree with the government that "the undifferentiating invocation of stock redemption principles in a reorganization case" such as this one is erroneous, and we decline to apply on a wholesale basis the "meaningful reduction" test in cases arising under § 356(a)(2).¹³ Accordingly, we hold that the district

12. Before the reorganization, the taxpayer owned 85 per cent of the two corporations. After the reorganization, he owned 62 per cent of the new corporation.

13. We are not unaware of several cases indicating that Sections 356(a)(2) and 302(b)(1) are to be read *in pari materia*,
(Continued on following page)

court erred in utilizing "meaningful reduction" analysis in this case. A contrary holding would render § 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations. And, even in that situation, disproportionate ownership—as in *Wright*—could result in a meaningful reduction.

Section 356(a)(2) requires that a "boot" be taxed as a dividend if it "has the effect of the distribution of a dividend." The focal point of our analysis, then, is the effect of the "boot" in the instant case, and we must examine all of the facts and circumstances surrounding its distribution in light of basic tax principles pertaining to dividends and reorganizations.

Under 26 U.S.C. § 316(a), "dividend" is defined as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits," either current or accumulated. Thus, a dividend is the severance of profits from the corporation and the distribution of those profits to the shareholders. *United States v. Phellis*, 257 U.S. 156, 170, 42 S.Ct. 63, 66 L.Ed. 180 (1921).

Footnote continued—

despite the absence of an express statutory relationship between them. *E. g., Hawkinson v. Commissioner of Internal Revenue*, 235 F.2d 747, 751 (2 Cir. 1956); *Ross v. United States*, 173 F.Supp. 793, 797, 146 Ct.Cl. 223, cert. denied, 361 U.S. 875, 80 S.Ct. 138, 4 L.Ed.2d 113 (1959). This is correct in that both provisions are usually triggered by pro rata distributions. However, the facts of the instant case illustrate why principles developed in § 302(b)(1) cases cannot be haphazardly applied in the context of a § 356(a)(2) reorganization. The Internal Revenue Service has stated that tests developed for § 302 may "in appropriate cases" serve as "useful guidelines for purposes of applying § 356(a)(2)." Rev. Rul. 74-516, 1974-2 Cum.Bull. 121. We agree with the government that the instant case is not among those "appropriate cases."

Section 301(c) provides that a dividend is to be included in the taxpayer's gross income.

The theory behind tax-free corporate reorganizations is that the transaction is merely "a continuance of the proprietary interests in the continuing enterprise under modified corporate form." *Lewis v. Commissioner of Internal Revenue*, 176 F.2d 646, 648 (1 Cir. 1949); Treas.Reg. § 1.368-1(b). See generally Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A.J. 40 (1969). Indeed, if the transaction does not involve the exchange of sufficient stock or securities, the judicially-created "continuity of proprietary interest" test destroys the transaction's treatment as a reorganization.¹⁴

If a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a "continuance of the proprietary interests in the continuing enterprise under modified corporate form," it follows that the pro rata distribution of "boot" to shareholders of one of the participating corporations must certainly have the "effect of the distribution of a dividend" within the meaning of § 356(a)(2). *King Enterprises, Inc. v. United States*, 418 F.2d 511, 189 Ct.Cl. 466 (1969); *Hawkinson v. Commissioner of Internal Revenue*, 235 F.2d 747 (2 Cir. 1956); *Ross v. United States*, 163 F.Supp. 793, 146 Ct.Cl. 223, cert. denied, 361 U.S. 875 (1959); *Love v.*

14. The purpose of the test is to ensure that the shareholders of the corporations involved in a reorganization retain a significant continuing equity interest in the reorganized business. See *Le Tulle v. Scofield*, 308 U.S. 415, 60 S.Ct. 313, 84 L.Ed. 355 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 56 S.Ct. 269, 80 L.Ed. 284 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue*, 287 U.S. 462, 53 S.Ct. 257, 77 L.Ed. 428 (1933); *Southwest Natural Gas Co. v. Commissioner of Internal Revenue*, 189 F.2d 332 (5 Cir.), cert. denied, 342 U.S. 860, 72 S.Ct. 88, 96 L.Ed. 647 (1951). See generally Sapienza, *Tax Considerations in Corporate Reorganizations and Mergers*, 60 Nw.L.Rev. 765 (1966); Fox & Fox, *supra*, n. 6, ¶ 4.02[5][a].

Commissioner of Internal Revenue, 113 F.2d 236 (3 Cir. 1940); *Rose v. Little Inv. Co.*, 86 F.2d 50 (5 Cir. 1936); *Commissioner of Internal Revenue v. Owens*, 69 F.2d 597 (5 Cir. 1934). Moreover, the legislative history of § 356(a)(2)'s predecessor statute makes clear that a distribution that would have been a dividend if made prior to the reorganization is subject to the same treatment when made as part of the transaction. H.Rep. No. 179, 68th Cong., 1st Sess., 14-15 (1924) [1939-1 Cum.Bull. (Part 2), 241, 252]; S.Rep. No. 398, 68th Cong., 1st Sess., 15-16 (1924) [1939-1 Cum.Bull. (Part 2), 266, 277].

Accordingly, § 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred. This inquiry is essentially a comparison of the effect of actual distribution and the effect of a hypothetical one. Prior to the merger in the instant case, LSC had retained earnings of approximately \$725,000. In the course of the merger, LSC shareholders received a pro rata distribution of \$625,000 as "boot". If no reorganization had taken place and LSC had made such a pro rata distribution, or if LSC had taken such action prior to the merger, there is no doubt that this would have been a dividend taxable as ordinary income. The same result should obtain where, as here, the LSC shareholders received a pro rata "boot" of \$625,000.¹⁵

15. The "boot" is to be treated as having been distributed by the acquired corporation—here LSC—rather than by the acquiring corporation. See *Commissioner of Internal Revenue v. Owens*, *supra*; *Ross v. United States*, *supra*; *James Armour, Inc.*, 43 T.C. 295 (1964). Our decision in *Davant v. Commissioner of Internal Revenue*, 366 F.2d 874 (5 Cir. 1966), cert. denied, 386 U.S. 1022, 87 S.Ct. 1370, 18 L.Ed.2d 460 (1967), is not to the contrary. There we recognized the general rule stated above, but looked to the acquired and acquiring corporations since both had the same shareholders. As we pointed out, the two corporations "were but different pockets in the same pair of trousers." 366 F.2d at 889.

Indeed, the legislative history of the predecessor to § 356(a)(2) offers virtually the same fact situation as an example of a transaction having the effect of a dividend distribution.¹⁶ The taxpayer should not be able to reap the benefits of capital gain treatment simply because he received his share of the distribution after the merger in the form of a "boot" rather than before the merger in the form of a dividend.

Taxpayer argues that we ignore economic reality by hypothesizing that LSC could have declared a dividend prior to the merger, since the corporation had only \$147,000 in cash on hand when the merger took place. Taxpayer thus asks us to erase approximately \$725,000 in retained earnings from the corporation's pre-merger balance sheet and pretend that these profits were never made. This we refuse to do. It is apparent that taxpayer, who controlled LSC made a considered decision to utilize the corporation's retained earnings for purposes other than

16. The House Report states:

The necessity for this provision may best be shown by an example: Corporation A has capital stock of \$100,000, and earnings and profits accumulated since March 1, 1913, of \$50,000. If it distributes the \$50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates. On the other hand, corporation A may organize corporation B, to which it transfers all its assets, the consideration for the transfer being the insurance by B of all its stock and \$50,000 in cash to the stockholders of corporation A in exchange for their stock in corporation A. Under the existing law, the \$50,000 distributed with the stock of corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12½ per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its \$50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the 12½ per cent rate on capital gain. Here again this provision prevents evasions.

House Report No. 179, *supra* at 14-15. Senate Report No. 398, *supra* at 15-16, gives the same example.

payment of a dividend. It cannot be said that LSC was unable to pay a dividend; rather, for reasons not revealed in the record, it chose not to do so. Moreover, despite taxpayer's protestations to the contrary, it seems clear that the merger operated as a device for "bailing out" LSC's retained earnings, which were evidently tied up in certain aspects of the business' operation.

Taxpayer also contends that our analysis in this case constitutes abrogation of the "step transaction" doctrine. We disagree. Under the doctrine, which has application in a variety of tax situations, all parts of a multi-step exchange or reorganization are grouped together to determine the appropriate tax treatment for the entire transaction, if the several steps are an essential and integral part of the overall plan. See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 62 S.Ct. 540, 86 L.Ed. 775 (1942); *Kanawha Gas & Utilities Co. v. Commissioner of Internal Revenue*, 214 F.2d 685 (5 Cir. 1954). However, the doctrine is certainly no bar to our comparing the "boot" distribution in the instant case with a hypothetical situation in which the pro rata distribution of LSC's retained earnings would obviously have been a dividend. If the doctrine forbids such an examination of the "boot" portion of the reorganization scheme, it would be impossible to determine whether the "boot" distribution had the effect of the distribution of a dividend. We are not treating the "boot" distribution as a separate step in the overall transaction but are rather analyzing the distribution in accordance with the requirements of § 356(a)(2).¹⁷

17. The doctrine's place in the reorganization context is plain, for when cash is received in a series of transactions in connection with a general reorganization plan, the taxable result may vary considerably depending upon whether the transactions are to be considered separately or as a whole and whether the

(Continued on following page)

Moreover, taxpayer's reliance on the step transaction doctrine seems bottomed on his view that the meaningful reduction test applies here and that the appropriate focus is control of the corporation.¹⁸ We again reject this approach, for, as we have previously pointed out, a majority shareholder in a small corporation will always become a minority shareholder in a large corporation that acquires the small one, so long as there is no commonality of ownership. Further, although taxpayer and the other LSC shareholders relinquished their control of LSC, they certainly did not part with their interests in the continuing corporate entity under the reorganization, i. e., MGIC. Taxpayer's approach also fails to address the effect of the "boot" distribution itself, an inquiry mandated by the plain language of § 356(a)(2).

Finally, we are compelled to note that our decision today does not signal a return to the now-discredited "automatic dividend" rule.¹⁹ We are concerned in this case

Footnote continued—

cash constitutes "boot" or the sole consideration in connection with a single step in the transaction. See 3 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION*, §§ 20.161 et seq. (1972). There is no doubt in the instant case that the "boot" was distributed pursuant to an overall plan of corporate reorganization.

18. Taxpayer cites and discusses various § 302 redemption cases. E. g., *Zenz v. Quinlivan*, 213 F.2d 914 (6 Cir. 1954); *Arthur D. McDonald*, 52 T.C. 82 (1969). As we have previously indicated, we will not haphazardly apply § 302 principles in § 356 cases. Moreover, the cases relied on by taxpayer only peripherally involve the step transaction doctrine and simply stand for the proposition that either the complete termination of a taxpayer's interest in a corporation or the substantial reduction of that interest does not result in dividend equivalency. The Supreme Court reaffirmed this principle in *Davis*.

19. This rule stemmed from language in *Commissioner of Internal Revenue v. Estate of Bedford*, 325 U.S. 283, 65 S.Ct. 1157, 89 L.Ed. 1611 (1945). The opinion was widely criticized, however, because it appeared to encompass all distributions, regardless

(Continued on following page)

with the effect of a pro rata "boot" distribution, not with the effect of a distribution on a non-pro rata basis. Obviously, the latter variety does not bear the earmarks of a classic dividend. Further, we do not totally reject the relevance of principles developed in § 302 redemption cases in the context of a corporate reorganization implicating § 356. However, such a blind application of those principles would be somewhat akin to hunting ducks with a deer rifle, since there are fundamental differences between the redemption of stock in a single corporation and the reorganization of two or more corporations that results in a "boot".

Accordingly, we hold that the district court erred in concluding that the meaningful reduction test of *Davis* was applicable here and that the "boot" received by the taxpayer was to be taxed as a capital gain. Because the distribution of the "boot" had the effect of the distribution of a dividend, § 356(a)(2) requires that it be taxed as ordinary income.²⁰

REVERSED.

Footnote continued—

of whether they were made on a pro rata basis. Accordingly, a string of lower court decisions have retreated from the rule and have examined, as we have done here, the facts and circumstances of each case in order to determine the effect of the distribution. *E. g., Hawkinson v. Commissioner of Internal Revenue, supra; Ross v. United States, supra.*

20. This case is obviously a complex one, and the court was aided by the excellent briefs and argument of both parties. We thus cannot say that this tax puzzle is one that "cometh not out save by fasting and by prayer," *Houston Textile Co. v. Commissioner of Internal Revenue*, 173 F.2d 464 (5 Cir. 1949) (Hutcheson, J.), although we certainly do not disparage either of those activities.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 76-3749

D. C. Docket No. 74-440-Civ-T-H

MANDELL SHIMBERG, JR. and
ELAINE F. SHIMBERG,
Plaintiffs-Appellees,

versus

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court for the
Middle District of Florida

Before BROWN, Chief Judge, and

THORNBERRY and CLARK, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Middle District of Florida, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed;

It is further ordered that plaintiffs-appellees pay to defendant-appellant, the costs on appeal to be taxed by the Clerk of this Court.

July 28, 1978

Issued As Mandate:

No. 78-698

Supreme Court, U. S.

FILED

DEC 21 1978

MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States
OCTOBER TERM, 1978

MANDELL SHIMBERG, JR. AND
ELAINE F. SHIMBERG, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES
IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

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UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE FIFTH CIRCUIT*

**MEMORANDUM FOR THE UNITED STATES
IN OPPOSITION**

The question presented in this federal income tax case is whether the court of appeals correctly held that pro rata cash distributions received by petitioner¹ and other shareholders, pursuant to a merger of

¹ "Petitioner" refers to Mandell Shimberg, Jr. His wife, Elaine F. Shimberg, is a petitioner only because she filed a joint income tax return with her husband for the taxable year at issue.

(1)

their corporation into a larger corporation, had the effect of the distribution of a dividend, and was taxable as ordinary income under Section 356(a)(2) of the Internal Revenue Code of 1954.

The pertinent facts are undisputed and may be summarized as follows: Petitioner was the president and principal shareholder of LaMonte-Shimberg Corporation (LSC), a Florida corporation engaged primarily in building and selling single family homes. He owned, directly or indirectly, approximately two-thirds of the stock of LSC. The remaining shares were owned by 19 unrelated stockholders (Pet. App. A2, A13).

In December 1970, LSC was merged into MGIC Investment Corporation (MGIC), a large financial corporation, the stock of which was listed and traded on the New York Stock Exchange. Prior to the merger, MGIC had outstanding 6,204,448 shares of common stock held by 5,191 stockholders of record. Pursuant to the merger agreement, the LSC shareholders received ratably in exchange for their stock, 32,132 shares of MGIC common stock outright, 32,132 additional shares in escrow, and \$625,000 in cash. Petitioner received 21,461 shares of MGIC stock outright, 21,461 shares in escrow, and \$417,449 in cash. As of the merger, the undistributed earnings and profits of each corporation exceeded \$625,000 (Pet. App. A2-A3, A13-A14).

On their joint tax return for 1970, petitioners reported gain resulting from the merger equal to the

cash they received as long-term capital gain. On audit, the Commissioner of the Internal Revenue Service determined a deficiency on the ground that the distribution of cash had the effect of a dividend and was taxable as ordinary income under Section 356(a)(2) of the Code. In this refund suit brought by petitioners in the United States District Court for the Middle District of Florida, the district court ruled that the cash received by petitioner and his fellow LSC shareholders in connection with the merger of LSC into MGIC did not have "the effect of the distribution of a dividend" within the meaning of Section 356(a)(2). It therefore upheld petitioner's claim to capital gain treatment for the cash he received as a result of the merger. In the district court's view, the test to be applied in determining whether the exchange had the effect of the distribution of a dividend "is whether the transaction resulted in a 'meaningful reduction' of the taxpayer's proportionate interest in the corporation under *United States v. Davis*, 397 U.S. 301 (1970) (Pet. App. A8). Since petitioner owned 66% of the stock of LSC prior to the merger and owned less than one percent of the stock of MGIC after the merger, the district court concluded that the merger resulted in "a radical change and meaningful reduction" in petitioner's interest in the continuing enterprise (Pet. App. A9).

The court of appeals reversed (Pet. App. A12-A26). As it observed, the "meaningful reduction" test of *Davis* was employed with respect to the stock redemption of a single corporation and cannot be indiscriminately applied in the context of a reorgani-

zation. In so ruling, the court stated that “[a] contrary holding would render § 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation’s shareholders, unless the same shareholders control both corporations” (Pet. App. A20).

1. The court of appeals correctly held that the cash distribution received by petitioners in connection with the merger of LSC into MGIC was taxable as a dividend under Section 356(a)(2). Section 356(a)(1) of the Code provides that if, in connection with a corporate reorganization as defined in Section 368, a shareholder receives not only stock in a corporation a party to the reorganization, but also money or other property, the shareholder shall recognize gain in an amount not in excess of the money or other property. Section 356(a)(2) provides that if the exchange has “the effect of the distribution of a dividend,” then each distributee shall treat as a dividend such an amount of the gain recognized that is not in excess of his ratable share of the earnings and profits of the corporation.

The decision below is in accord with an unbroken line of authority since the enactment of the predecessor of Section 356(a)(2) as Section 203(d)(2) of the Revenue Act of 1924, ch. 234, 43 Stat. 257. These decisions uniformly hold that where the shareholders of one of the corporations participating in a reorganization receive in exchange not only stock but also a

pro rata distribution of cash, the pro rata distribution of cash has the effect of a dividend.² A number of these decisions relied upon the legislative history that accompanied the Revenue Act of 1924. The pertinent committee reports state that if, in the course of a reorganization, a distribution of cash is made to the shareholders of one of the participating corporations, and the distribution would have been a dividend if made prior to the reorganization, then it should also be treated as a dividend when made in the course of the reorganization. H.R. Rep. No. 179, 68th Cong., 1st Sess. 14-15 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 15-16 (1924).

Given the clearly articulated intent of Congress, the court of appeals correctly recognized that Section 356(a)(2) requires a determination whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred. Here, prior to the merger, LSC had retained earnings of approximately \$725,000. In the course of the merger, its shareholders received a

² E.g., *Commissioner v. Owens*, 69 F.2d 597 (5th Cir. 1934); *Commissioner v. Forhan R. Corp.*, 75 F.2d 268 (2d Cir. 1935); *Rose v. Little Investment Co.*, 86 F.2d 50 (5th Cir. 1936); *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940); *Hawkins v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); *King Enterprises, Inc. v. United States*, 418 F.2d 511, 519-521 (Ct. Cl. 1969); *Woodward v. Commissioner*, 23 B.T.A. 1259 (1931); *Woodard v. Commissioner*, 30 B.T.A. 1216 (1934); *Sheldon v. Commissioner*, 6 T.C. 510 (1946); *Estate of Hill v. Commissioner*, 10 T.C. 1090 (1948).

pro rata distribution of \$625,000 in cash. If the merger had not taken place and LSC had made such a distribution or if LSC had made the distribution prior to the merger, it is beyond dispute that the cash would have been a dividend taxable at ordinary income rates. Section 356 requires the same result where the shareholders receive the cash pursuant to the terms of the merger. Under the statute, it makes no difference that the shareholders receive the cash after the consummation of the merger rather than as a dividend prior to the merger. In both cases, Congress determined that the distribution was a dividend taxable as ordinary income.

2. Contrary to petitioner's assertion (Pet. 8-11), this Court's decision in *United States v. Davis*, 397 U.S. 301 (1970), supports, rather than conflicts with, the decision below. *Davis* arose, not under Section 356, but under Section 302, which deals with the redemption of the stock of a single corporation and provides, *inter alia*, for dividend treatment of the proceeds of the redemption if it is "essentially equivalent to a dividend" (Section 302(a) and (b)(1)). The fact that Section 356(a)(2) employs the phrase "has the effect of the distribution of a dividend" shows that Congress mandated dividend treatment for pro rata distributions in redemptions and reorganizations. But apart from this common attribute between the two provisions, they are not identical and the distinct transactions which they address call for

different analyses and application.³ Section 302 applies to redemption of the stock of a single corporation. On the other hand, Section 356 applies to reorganization transactions which (except for recapitalizations) necessarily involve two or more corporations. Given these differences in factual contexts, the test of *Davis*—that a redemption must result in a "meaningful reduction" of the shareholder's proportionate interest in the corporation in order to obtain preferred capital gain treatment—is not freely transferable to the context of a merger or consolidation transaction involving two or more corporations. As the court of appeals properly pointed out (Pet. App. A19-A20), a simple comparison of the pre-merger fractional interests of shareholders in separate and autonomous corporations with their post-merger interests in the single united corporation would almost invariably show substantial reductions in individual

³ See *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). There are a number of specific differences between the two provisions. Section 356(a)(2) subjects to dividend treatment not more than the gain recognized on the exchange, while Section 302 applies dividend treatment to the whole amount distributed, even though, computed as an exchange, the exchange results in a loss rather than a gain. Dividend equivalence under Section 302 is determined by application of the attribution rules of Section 318. These attribution rules are not applicable to the determination under Section 356(a)(2). Finally, only the earnings of the corporation whose shareholders receive cash are available for dividend treatment under Section 356(a)(2). If the two corporations were regarded as one, as under Section 302, the earnings of both corporations would be available.

fractional interests, particularly where, as here, a small enterprise was merged into a large corporation. For if that were the appropriate analysis, Section 356(a)(2) would be rendered substantially meaningless since there would, as here, almost always be a marked reduction in percentage holdings. Thus, in the reorganization context, the appropriate inquiry under Section 356 is whether there was a pro rata distribution of cash to the shareholders of one of the merging corporations. If, as in the instant case, there was such a pro rata distribution, the decisions uniformly hold that the distribution has the effect of a dividend.

3. Contrary to petitioner's further argument (Pet. 11-13), the decision below does not conflict with *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973). There, the taxpayer and a business associate managed three corporations in related enterprises, and owned stock in them in different proportions. They wished to unite two of the corporations into a single entity so that their interests in the resulting corporation would be in approximately the same proportion as their interests in the other corporation. Because one of the two corporations was worth twice as much as the other, the parties could not accomplish their goal through a simple merger. It was accordingly necessary for the taxpayer to reduce his interest in the resulting corporation. This was done by the payment of cash to the taxpayer to reflect his greater entitlement and to produce a new entity with the

desired percentage holdings. Since the taxpayer was the principal stockholder in both corporations, the court treated the transaction as though there had been a single corporation throughout, and as though the taxpayer's interest in that hypothetical single corporation had been redeemed and reduced. Accordingly, the court employed the *Davis* test applicable to stock redemptions of single corporations.

As the court of appeals observed (Pet. App. A19), application of the "meaningful reduction" test in *Wright* was not illogical given the court's recasting of the transaction. Whether or not *Wright* was correctly decided, the court below correctly concluded that its particularized facts provide no model for the treatment of independent and autonomous corporations with different shareholders. Absent the commonality of ownership that existed in *Wright*, there is no basis for recasting the transaction in the instant case as a redemption. *Wright* is therefore distinguishable. Indeed, in an earlier decision where two corporations with the same shareholders were unified by virtue of a reorganization transaction, the court below recognized that such a situation called for an analysis different from that normally appropriate under Section 356(a)(2). See *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. McCREE, JR.
Solicitor General

DECEMBER 1978